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Department of the Treasury
**Internal Revenue Service**

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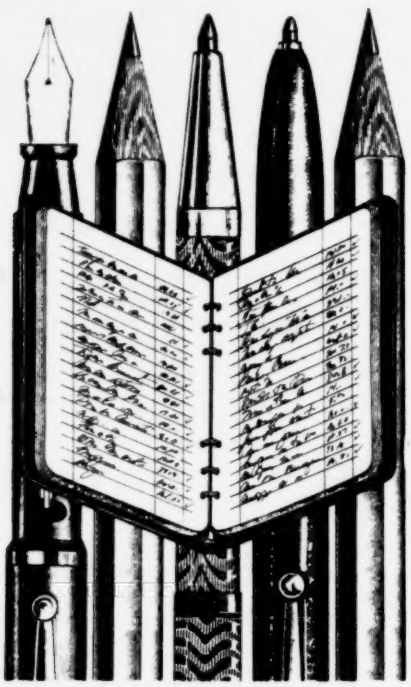
# Interest Expense

For use in preparing
**1980 Returns**



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## Introduction

Interest is an amount paid for the use of borrowed money. The type of deduction you may take depends on whether you borrowed the money for personal use, for rental or royalty property, or for your business.

The following lists tell you what expenses generally are deductible or not deductible. Most of these items are discussed in this publication.

## Items You May Deduct As Interest

Mortgage interest
"Points," if you are a borrower
Mortgage prepayment penalty
Redeemable ground rents
Interest on a personal loan
Interest on a business loan
Note discount interest
Installment plan interest
Unstated interest
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Bank credit card plan interest

## Items You May Not Deduct As Interest

"Points," if you are a seller
Nonredeemable ground rents
Interest relating to tax-exempt income
Interest paid to carry single-premium life insurance
Interest owed to related taxpayers
Service charges
Loan fees
Credit investigation fees
Premium on a convertible bond

## General Rules

To deduct interest on a debt, you must be legally liable for the debt. You may not deduct payments you make for someone else if you were not legally liable to make them. Both the lender and the borrower must intend that the loan be repaid.

***Example 1.*** You lend money to your son, hoping to be repaid when he is able. Because no true debtor-creditor relationship is created, he is not legally liable to pay the debt. He may not deduct any interest paid.

***Example 2.*** You cosign a note for a loan made by a bank to your son. Your son is a student. You and your son are jointly liable on the note. You may deduct any interest you pay on the loan in the year you pay it.

**Actual payment.** You must pay the interest before you may deduct it.

***If you use the accrual method*** of accounting, you may deduct interest over the period it accrues, regardless of when you pay it.

***Example.*** You borrow $1,000 in September 1980, payable in 90 days at 12% yearly interest. In December 1980 you make the payment with a new note for $1,030 due the following March. If you use the cash method of accounting, you may not deduct the $30 in the year you gave the new note because you did not actually pay the interest. However, if you pay the $30 in December 1980 and give a new note for $1,000, you may deduct the interest.

**Interest paid in advance.** If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread the interest over the tax years to which it applies. You may deduct in each year only the interest for that year.

## Where to Deduct

Where you deduct your interest expenses on your tax return, depends on how you use the money you borrowed.

**Deduct interest of a personal nature,** such as home mortgage interest, on Schedule A (Form 1040).

Interest charged on any unpaid amount of income tax you owe is personal interest, even if it relates to your trade or business.

**Deduct interest on a business loan** on Schedule C (Form 1040). See Publication 334, *Tax Guide for Small Business.*

**Deduct interest on a loan for income-producing rental or royalty property** that is not used in your business in Part II of Schedule E (Form 1040).

***Example.*** You rent out part of your home and have borrowed money to make repairs. You may deduct the part of the interest payment for the rented part in Part II of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040).

**Deduct interest on farm business loans** on Schedule F (Form 1040). See Publication 225, *Farmer's Tax Guide.*

**Deduct interest on margin accounts** on Schedule A (Form 1040) for the year you paid it. Interest on these accounts is considered paid when the broker is paid, or when the interest becomes available to the broker through your account.

## Mortgage Interest

Mortgage interest is a common type of personal interest. You may deduct only the interest part of your mortgage payment. If your records do not show the interest you paid, you should get a statement of that information from the lender who holds your mortgage.

***Example.*** Frank and Evelyn Jones bought a new home on May 3 and sold their old home on May 5. During the year they made interest payments of $121.78 on the old home and $1,432.05 on the new home. The settlement sheet for the sale of the old home showed $2.76 interest for the 4-day period in May up to, but not including, the date of sale. The sum of these amounts, $1,556.59, is their mortgage interest deduction for the year.

**Separate returns.** If you and your spouse file separate returns, each of you may deduct only the interest each pays on mortgaged property held as tenants by the entirety.

**Graduated Payment Mortages (GPM)** under section 245 of the National Housing Act. GPM payments go up every year for a number of years and stay the same after that. During the early years, payments are less than the amount of interest owed on the loan. Unpaid interest is put off and added to the loan principal. Future interest is figured on the increased unpaid mortgage loan balance.

You may deduct the interest you actually paid during the year if you are a cash method taxpayer. You may deduct the amount accrued each year if you are an accrual method taxpayer.

**Mortgage assistance payments.** You may not deduct any interest that is paid under the mortgage assistance program provided by section 235 of the National Housing Act. But you may deduct any real estate taxes that you pay.

**"Points" paid by a borrower.** The term "points" is sometimes used to describe the charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is ***only*** for the use of money, it is interest.

You may fully deduct the amount you pay as points in the year of payment only if the loan is used to buy or improve your principal home and is secured by that home. The charging of points has to be an established business practice in your area. The deduction may not be more than the number of points generally charged in your area.

If these conditions are not met, points are treated as interest paid in advance. They must be spread over the life of the mortgage, and are considered as paid and are deductible over that period.

***Points charged for specific services*** by the lender for the borrower's account are not interest. Examples of fees for services not considered interest are the lender's appraisal fee, preparation costs for the mortgage note or deed of trust, settlement fees, and notary fees. Points charged for services for getting a Veterans Administration loan are not interest. See Example 2.

You may not deduct expenses to acquire a mortgage either as interest or as current business expenses. These expenses, including commissions, abstract fees, and recording fees, are capital expenses. If these expenses are for business or income-producing property, you may deduct them on a pro rata basis over the life of the mortgage. Do not add them to the basis of the property.

***Example 1.*** Don Smith borrowed $48,000 to buy his $60,000 home. He paid the lender, in addition to interest at 12%, a loan processing fee of $1,440 (three points). None of the fee was for specific services. The charging of points was an established business practice in the area and the number of points was not more than that generally charged in the area. The $1,440 loan processing fee (points) is interest. Don may deduct it in the year of payment.

***Example 2.*** Jan Green got a loan from a bank to buy her home. The loan was insured by the Veterans Administration. Jan paid the bank a loan origination fee. The fee was 1% of the amount of the loan. It was charged in addition to the maximum rate of interest permitted on VA loans. The 1% loan origination fee (one point) is not interest. Jan may not deduct it.

**"Points" paid by the seller.** The term "points" also is used to describe loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller may ***not*** deduct these amounts as interest. But these charges are a selling expense that reduce the amount realized.

**Reverse mortgage loans.** A reverse mortgage loan is a loan that is based on the value of your home and is secured by a mortgage on your home. The lending institution pays you the loan in installments over a period of months or years. The loan agreement may provide that interest will be added to the outstanding loan balance monthly as it accrues. If you are a cash method taxpayer, you deduct the interest on a reverse mortgage loan when you actually pay it, not when it is added to the outstanding loan balance.

**Mortgage prepayment penalty.** If you pay off your mortgage early, you may have to pay a penalty. You may deduct that penalty as interest.

**Tenant-stockholders in a housing cooperative.** You may deduct your part of the interest on the cooperative's debt. You may also deduct your share of points paid by the cooperative in the year you became a tenant-stockholder.

**Ground rents.** If you make payments on a redeemable ground rent, you may deduct them as interest. Payments on a nonredeemable ground rent are not interest. You may deduct them as rent if they are a business expense, or if they are for rental property held to produce income.

Payments made to buy the lessor's entire interest in the title are not ground rents. You may not deduct them.

***Redeemable ground rents*** have the following conditions:

1) The lease of land must be for a term of more than 15 years, including renewal periods, which is freely assignable by the lessee,
2) The leaseholder has a present or future right (under state or local law) to terminate and acquire the lessor's entire interest in the land by paying a specific amount, and
3) The lessor has primarily a security interest to protect the rental payments to which he or she is entitled.

There are instances in which the term ground rent is used but, the conditions just described are not met.

***Example.*** An apartment house owner allows tenants to use a swimming pool, tennis courts, and other recreational facilities for which a monthly ground rent is charged. This ground rent is a personal expense. The tenants may not deduct it.

**Note discount interest.** Sometimes the face value of your note is more than the amount you actually receive. This happens when the interest is subtracted from the face amount of the note and you receive the balance. If you use the cash method, you may deduct the interest only in the year you make payments. If you use the accrual method, you may deduct the interest as it accrues.

***Example.*** You signed a note for $1,200 at 12% interest, on March 27, agreeing to repay it in 12 equal installments beginning on April 28. The interest ($1,200 × 12% = $144) was subtracted from the face value of the note and you received $1,056. If you use the cash method, the interest is considered to be repaid in 12 installments of $12 each. You may deduct $108 ($12 × 9) for the first year. If you missed two payments during the first year, you would deduct $84. If you use the accrual method, figure the deduction by spreading the interest over the period in which it accrues. You may deduct $108 (9/12 of $144) in the first year and $36 (3/12 of $144) the next year.

***Acceleration of deductible interest.*** Under certain circumstances, you may use a method other than the one described in the above example to find your deductible interest expense on a loan payable in monthly installments.

***"Rule of 78s".*** When you borrow money from a lender that will charge you interest under the "Rule of 78s" if you repay the loan in full before maturity, you may figure your deductible interest using this method. With this method, you pay more interest in the first month of the loan and less in each following month.

This method is based on the sum of the months' digits. The lender multiplies the yearly interest expense on the note by a fraction to determine the amount of monthly interest. The denominator (bottom part) of the fraction, which always remains the same, is the sum of the digits for the number of installment payments of the loan. So, the denominator of a 12-month loan is 78 (12 + 11 + 10 . . . + 1 = 78). The denominator of a 60-month loan is 1,830 (60 + 59 + 58 . . . + 1 = 1,830). The numerator (top part) of the fraction, which changes from month to month, is the number of installments remaining on the note. So, the fraction for figuring the interest you paid in the second month of a 12-month installment loan is 11/78.

***Example.*** You are a cash method, calendar year taxpayer. On November 1, you borrowed $681 from a bank and signed a note for $720. The note is payable in 12 monthly installments of $60, beginning December 1, and after that on the first day of each month until November 1 of the next year. The installment note provides that if you repay the loan in full before

maturity, the part of the total interest of $39 ($720 − $681) earned by the lender on your note is to be figured on a sum of the months' digits basis. If you actually paid the December 1 installment, you may claim an interest deduction of $6 (12/78 × $39 = $6) for that year.

You may use this method to figure your interest expenses on both installment loans made at a discount and add-on interest loans. Add-on interest loans are loans in which the interest is added to the principal amount.

**Late payment charge by a public utility.** You may deduct a late payment charge if it was not for a specific service the public utility did for you.

## Installment Buying

When you buy property on the installment plan, you may deduct your interest payments if they are separately stated, or if they can be determined and proved.

**Revolving charge account finance charges.** When you buy personal property, such as clothing, jewelry, furniture, or appliances on the installment plan using a revolving charge account, there is usually a separate finance charge. You may deduct the ***total*** amounts of these finance charges as interest.

***Example.*** You bought a stove for $300 and charged it to your revolving charge account. If you pay the balance within 30 days after you are billed, there is no extra charge. If you make installment payments, you will be charged a monthly finance charge of 1½% on the unpaid balance. You may deduct your total finance charges as interest.

**Credit card finance charges.** You may deduct as interest the finance charges added to your monthly statements. The finance charges are figured at an annual percentage rate and are based on the unpaid monthly balances.

***Bank credit card.*** You may deduct finance charges on your bank credit card account balance if no part of the charge is a service charge, loan fee, credit investigation fee, or similar charge.

***One-time charges.*** You may deduct a one-time charge for each new cash advance and each new check and overdraft advance added to your bank credit card account balance. No part of the charge can be a service charge, loan fee, credit investigation fee, or similar charge.

***Example.*** You bought a chair for $200 and charged it to your First National Bank Credit Card. The bank bills you directly and charges your account 1½% of the unpaid balance each month, showing the charge as a finance charge. If no part of the charges are carrying charges, loan fees, credit investigation fees, or similar charges, you may deduct as interest the entire amount of the finance charges you paid.

**Unstated interest.** If you make installment payments under a contract that has a sale price of more than $3,000 and includes no interest, or only a low stated interest, you may be able to deduct unstated interest. For more information on unstated interest, see Publication 537, *Installment and Deferred-Payment Sales.*

**Educational services.** You may deduct interest on installment payments for educational services, such as tuition and lodging.

**Retail installment contract finance charges.** You may deduct as interest separately stated finance charges figured under an annual percentage rate shown in a retail installment contract. You also may deduct any fee you are charged for prepaying the contract.

## Refunds of Interest

If you receive a refund of interest in the same tax year you pay it, you must reduce your interest expense deduction by the amount refunded to you. However, if you receive a refund of interest you deducted in an earlier year, and the deduction decreased your tax, you must include the refund in income in the year you received it.

***Example.*** During 1980 you paid $200 interest on your loans with a credit union. On June 30, 1980, a $10 interest refund was credited to your account. On December 31, 1980, a $20 interest refund was credited to your account. Your net deduction for interest on your loans with the credit union is $170 ($200 paid minus $30 refunded).

If you received the second refund after December 31, 1980, you deduct $190 for interest paid the credit union in 1980. Include the $20 refund in your 1981 income to the extent this interest deduction reduced your tax in 1980.

## Items You May Not Deduct

Some interest payments are not deductible. Certain expenses similar to interest are not deductible.

**Interest relating to tax-exempt income.** You may not deduct interest on money you borrow to buy tax-exempt securities. Also, you may not deduct the interest if the borrowed money is placed in a fund or account used to buy tax-exempt securities.

**Single-premium life insurance or endowment contract.** You may not deduct interest on money you borrow to buy a single-premium life insurance, endowment, or annuity contract. This includes:

1) Policies on which you pay almost all the premiums within 4 years from the date of purchase, and
2) Policies on which you deposit an amount with the insurer to pay future premiums.

You may not deduct interest on a loan that is used to buy stock if the collateral on the loan is a single-premium annuity contract.

See *Systematic Borrowing on Insurance*, later in this publication.

**Capitalized interest.** You may not deduct interest expenses you capitalize as interest. See Publication 535, *Business Expenses and Operating Losses.*

**Penalties.** You may not deduct fines and penalties, regardless of their nature.

**Interest owed to a related taxpayer.** If you use the accrual method of accounting, you may not deduct unpaid interest you owe a related taxpayer unless the related taxpayer uses:

1) The accrual method, or
2) The cash method and the interest is paid within 2½ months after the end of your tax year.

For this rule, related taxpayers are:

1) Members of the same family—only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and your lineal descendants (children, grandchildren, etc.),
2) You and a corporation in which you own directly or indirectly more than 50% of the stock,
3) You and a trust created by you,
4) A trust and a beneficiary of the trust,
5) A trust and the beneficiary of another trust if both trusts were created by you, and
6) You and an exempt charitable or educational organization controlled directly or indirectly by you or a member of your family.

**Rental payments.** If you live in your house before your final settlement, any payments you make for that period are rent, not interest. This is true even if the settlement papers call them interest. You may not deduct these payments.

**Amortization of bond premium.** You may choose to amortize the premium you pay to buy taxable bonds. If you make this choice, you reduce your basis of the bonds by a part of the premium each year over the life of the bond. You may deduct the amount by which you reduce the basis for the year as a miscellaneous deduction on Schedule A (Form 1040).

The choice applies for the year you make it and for all later years. It applies to all similar bonds you own in the year you make the choice, and to similar bonds you acquire in later years.

***Tax-exempt bonds.*** You must amortize the premium and reduce the basis of the tax-exempt bonds. However, you may not deduct the amortized premium.

For more information, see Publication 550, *Investment Income and Expenses.*

**Premium on a convertible bond.** If you paid a premium for a convertible bond, you may not amortize or deduct the amount of the premium for the conversion feature of the bond.

## Systematic Borrowing on Insurance

You may not deduct interest on money you borrow to buy a life insurance, endowment, or annuity contract if you plan to systematically borrow part or all of the increases in the cash value of the contract.

This rule applies to all amounts paid or accrued in tax years beginning after 1963, un-

less you meet one of the four *Exceptions*, explained later. It applies whether you are the insured, payee, or annuitant under the contract. The rule does not apply to contracts you entered into before August 7, 1963, unless your contract was bought or acquired after that date, other than by gift, bequest, or inheritance. You may not deduct the interest that is based on the entire amount borrowed (directly or indirectly) to buy or carry the contract. It is not limited to the borrowing of increases in the cash value.

**Determining the existence of a plan that contemplates systematic borrowing** must be on the basis of all facts in each particular case. Unless you show otherwise, in the case of borrowing in connection with premiums for more than 3 years, as explained in *4) The 7-year exception*, the existence of a plan will be presumed. The mere fact that you do not borrow to pay a premium in a particular year does not mean there is no plan.

**If the stated annual premiums vary in amount,** then, for determining the existence of a plan, borrowing in connection with any premium that is more than the amount of any other premium on the contract may be considered borrowing to pay premiums for more than one year. This rule does not apply if the borrowing is in connection with a substantially increased premium, as explained under *4) The 7-year exception.*

**Direct or indirect borrowing.** A plan may contemplate direct or indirect borrowing of increases in cash value to pay premiums. Borrowing may be from an insurance company, a bank, or from any other source. Such a plan need not involve a pledge of the contract, but may contemplate unsecured borrowing or the use of other property.

***Example.*** Frank Hay borrowed $100,000 from a bank to buy securities. He borrowed another $100,000 from a second bank to repay his loan at the first bank. He sold the securities, using the proceeds to pay premiums on a contract of cash value life insurance. He may not deduct interest on the loan from the second bank.

**Exceptions.** If any of the following four exceptions applies, you may deduct interest paid or incurred to buy or continue a contract.

***1) Interest not more than $100 exception.*** If the total annual interest paid or accrued with respect to one or more plans, for which no deduction would otherwise be allowed, is not more than $100, the deduction will be allowed. If the interest is more than $100 for the tax year, the entire amount is subject to the general rules, discussed earlier, for disallowance of the deduction.

***2) Unforeseen events exception.*** If the interest was paid or accrued on a debt incurred because of an unforeseen substantial increase in financial obligations, the deduction will be allowed. For example, you may deduct the interest paid on a loan against the cash value of a contract if the loan was incurred by you because of large unexpected medical expenses or an unexpected substantial decrease in income, whether or not the loan was used to pay a premium on the contract.

***3) Trade or business exception.*** If you have the debt in your trade or business, you may deduct the interest. Thus, if you pledge an insurance policy as part of the collateral for a loan, your interest deductions will be allowed if you can show that the amounts you borrowed were actually used to finance an expansion of inventory or similar business needs. Borrowing to finance business life insurance (such as keyman, split-dollar, or stock retirement plans) is not considered to be in connection with your trade or business.

***4) The 7-year exception.*** You are allowed a deduction if you did not borrow to pay any part of four of the annual premiums due during the 7-year period. The 7-year period begins with the date the first premium on the contract was paid. If the premiums are payable other than annually (monthly, quarterly, etc.), the annual premium is the total of the premiums due for the year. If there is a substantial increase in the premiums, a new 7-year period for the contract begins on the date the first increased premium is paid. If you enter into a contract with very low premiums for the first 4 years, and the premiums are later greatly increased, the 7-year period may begin again in the fifth year when the increase takes place.

You may borrow directly or indirectly on more than one annual premium on a contract during the 7-year period. If you do, you must first apply the borrowed amount to the premium for the current policy year. The current policy year is the policy year beginning with or within your tax year. Then it applies to premiums for previous policy years beginning with the most recent one. This does not include any previous year if you have a debt outstanding on the premium for that year. If the borrowed sum is more than the premiums paid for the current and previous policy years and you have deposited premiums in advance of their due date, the excess borrowing applies to the premiums deposited for succeeding policy years beginning with the next year.

***Example 1.*** Mark Brown, a calendar year, cash method taxpayer, bought a $100,000 insurance policy with annual premiums of $2,200 on January 2, 1976. For the first 4 policy years, he does not borrow money to pay the premiums. On January 2, 1980, he borrows $10,000 on the policy. This borrowing applies first to paying the premiums for 1980, and then to paying the premiums for 1979, 1978, 1977, and 1976 (in part). He has not paid at least 4 out of the first 7 years of premiums by means other than borrowing under a plan, as previously discussed. He may not deduct the interest paid on the $10,000 in 1980.

***Example 2.*** In Example 1, Mark Brown bought the insurance policy, and paid the first premium on January 2, 1978. He then deposited an amount equal to the second and third premiums, all by means other than borrowing. On January 2, 1979, he deposited an amount equal to the fourth, fifth, and sixth annual premiums, and borrowed $4,400 on the policy. This borrowing is considered for the premiums paid for the policy years 1979 and 1978. On January 2, 1980, he deposits an amount equal to the seventh, eighth, and ninth annual premiums, and borrows $6,600 on the policy. The $6,600 debt applies first to the premiums paid in 1980, and then to premiums deposited for 1981 and 1982. He may not deduct interest paid on the $11,000 debt in 1980. The interest deduction will not be allowed for 1979.

**Cash method taxpayer.** If you are a cash method taxpayer, you may deduct interest on a life insurance loan only in the tax year in which you paid the interest. You have not paid interest when the lender adds the interest to the principal of the loan because the payment becomes overdue.

**Accrual method taxpayer.** If you are an accrual method taxpayer, you must take the deduction when the liability to pay accrues.

## Limit on Investment Interest

If you paid or accrued interest during 1980 on money you borrow to buy investment property or net lease property, the amount of interest you can deduct may be limited. Use Form 4952, *Investment Interest Expense Deduction,* to figure your total deduction for investment interest. There is no limit on the deduction for personal (nonbusiness and noninvestment) interest.

**Limit.** Your deduction for investment interest expense is limited to the sum of:

1) Your net investment income, and
2) $10,000 ($5,000 if you are married filing separately), and
3) If your property is subject to a net lease, any amount by which the allowable deductions, other than the deduction for depreciation, for the property are more than the rental income from the property for the tax year.

Your net investment income is your investment income minus your investment expenses.

You can take an additional $15,000 deduction ($7,500 if you are married filing separately) if you incurred investment interest when you acquired stock in a corporation or partnership interest and you, your spouse, and children own 50% or more of the stock or the capital interest in that enterprise. If the amount of the interest is less than $15,000 ($7,500 if you are married filing separately), your additional deduction is limited to the amount of the interest.

Interest deductions that are disallowed under these rules can be carried to future years. However, your deduction is subject to certain limits.

For more information on the limit on investment interest, see Publication 550.

**Nonrecourse financing.** If you use nonrecourse financing to invest in certain tax shelter activities, your interest and other deductions may be subject to an "at risk" limit. For more information, see *At Risk (Tax Shelter) Limitations* in Publication 535, *Business Expenses and Operating Losses.*



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